
IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

LILLIAN E. YAEGER,

Respondent

EMMA M. HEBER AND ESTATE OF HENRY D. HEBER, DECEASED,
EMMA M. HEBER, ADMINISTRIX,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE COMMISSIONER

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IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 20085

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

LILLIAN E. YAEGER,

Respondent

No. 20086

EMMA M. HEBER AND ESTATE OF HENRY D. HEBER, DECEASED,
EMMA M. HEBER, ADMINISTRIX,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE COMMISSIONER

OPINION BELOW

The memorandum findings of fact and conclusions of law of the Tax
Court (I-R. 50-74) are not officially reported.

JURISDICTION

The petition for review filed by Mrs. Heber ¹/₁ involves federal

/ The Estate of Henry D. Heber is a petitioner solely because Mr.
Heber filed joint returns for the taxable years with his wife, Emma
Heber.

income taxes for the years 1956, 1957, and 1958 in the amounts of \$291.24, \$7,797.50 and \$741.56, respectively. (I-R. 96, 104-107.) The Hebers filed joint income tax returns for the taxable years with the District Director of Internal Revenue for the District of Los Angeles, California.

On August 29, 1962, the Commissioner mailed a notice of deficiency to the Hebers for 1956, 1957, and 1958 asserting deficiencies in the respective amounts of \$1,273.89, \$7,163.57, and \$304.66. (I-R. 24-29.) Within ninety days thereafter, on November 27, 1962, the Hebers filed a petition with the Tax Court for a redetermination of the deficiencies under the provisions of Section 6213(a) of the Internal Revenue Code of 1954. (I-R. 20-29.) The decision of the Tax Court was entered December 2, 1964. (I-R. 96.) The case is brought to this Court by a petition for review filed on March 1, 1965, within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. (I-R. 104-107.)

The Commissioner's protective petition for review involves federal income taxes of Lillian Yaeger for 1955 through 1958 in the respective amounts of \$4,437.93, \$59.12, \$1,389.78, and \$15.40. (I-R. 87, 97-100.) Miss Yaeger's income tax returns for the taxable years were filed with the District Director of Internal Revenue for the District of Los Angeles, California. On August 29, 1962, the Commissioner mailed notices of deficiency to her for the taxable years 1955 through 1958 asserting deficiencies in the respective amounts of \$7,248.54, \$2,753.21, \$2,929.99 and \$1,177.30. (I-R. 9-14.)

thin ninety days thereafter, on November 23, 1962, Miss Yaeger filed a petition with the Tax Court for a redetermination of the deficiencies under the provisions of Section 6213(a) of the Internal Revenue Code of 1954, within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. (I-R. 1-14.) The decision of the Tax Court was entered on December 2, 1964. (I-R. 87.) The case is brought to this Court by a protective petition for review filed on February 19, 1965, within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. (I-R. 97-100.)

Jurisdiction in both appeals is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954. By order of this Court dated May 17, 1965, the Heber and Yaeger cases were consolidated for briefing, argument, and decision. (I-R. 135-137.)

QUESTIONS PRESENTED

Where Mrs. Heber and Miss Yaeger had been partners in the ownership of certain real property and in 1944 executed an agreement terminating the partnership and dividing the properties, with Mrs. Heber receiving a vested interest of a life estate in an undivided one-half of the properties, as determined by the California state court,

1. Is Mrs. Heber taxable on her share of the rental income from the properties, which she received in 1956 through 1958, as ordinary income, as the Tax Court held, or at capital gains rates, as Mrs. Heber contends?

2. In the event this Court should reverse the Tax Court on Mrs. Heber's appeal, did Miss Yaeger actually own the entire amount of the net rental income earned by the former partnership properties, including the portion she transmitted to Mrs. Heber, so as to be taxable on all of it as ordinary income during the taxable years?

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

* * *

(5) Rents;

* * *

(13) Distributive share of partnership gross income;

* * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

* * *

(3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *

(26 U.S.C. 1958 ed., Sec. 1222.)

STATEMENT

The facts as stipulated by the parties (I-R. 44-49) and as found by the Tax Court (I-R. 51-65) may be summarized as follows:

Mrs. Heber and Miss Yaeger had been friends and companions since 1928. During the year 1935, and for a number of years thereafter, they resided together in Fullerton, California. Mrs. Heber has been a registered nurse since 1927. Miss Yaeger has been a real estate broker for over 50 years. (I-R. 52.)

On September 2, 1939, Mrs. Heber entered into a partnership agreement with Miss Yaeger under the terms of which they acknowledged that they were the equal owners of certain properties described therein as parcels 1 and 2; that they intended to acquire additional properties in which they were to have an equal interest; that they were to own and operate these and other properties as equal partners; that should either partner become dissatisfied, or desire to withdraw, such partner should not be permitted to do so before making a proposal either to sell or purchase the undivided one-half interest in the fee ownership of properties owned by the other party; and that in the event no sale occurred within a period of thirty days, the partnership was to be dissolved by operation of law. In the event of a dissolution of the partnership, the properties or the proceeds thereof were to be divided equally between Mrs. Heber and Miss Yaeger. (I-R. 52-53.)

Parcels 1 and 2, which were located in Fullerton, California, contained certain improvements consisting of buildings which produced rental income. Legal title to Parcels 1 and 2 was held by Security-First National Bank of Los Angeles as trustee for the partnership. After the execution of the partnership agreement on September 2, 1939, the partnership acquired a liquor store and additional properties

designated as Parcels 3, 4, 5, and 6, representing vacant lots, title to which was transferred to Miss Yaeger's attorney. In January or February of 1944, the partnership also acquired some property designated as Parcel 7, which contained a number of citrus trees, but was not productive of income. All of the properties of the partnership were managed solely by Miss Yaeger. Mrs. Heber did not participate in their management. (I-R. 53-54.)

On August 10, 1944, Mrs. Heber and Miss Yaeger executed a termination agreement which recited that they had formed a partnership on September 2, 1939, relating to their property holdings and provided in part that (I-R. 54):

[T]he parties hereto * * * desire to clarify and modify the terms of said documents [the deeds to the various properties and the partnership agreement], as well as covenant and agree by the terms hereof to partition and divide said properties, as hereinbefore set forth.

This termination agreement also provided that Parcels 1 through 6 were to be conveyed to Miss Yaeger, with a life estate in and to one-half of the rents, issues and profits to Parcels 1 through 7 (Parcels 7 having previously vested in Miss Yaeger) being reserved to Mrs. Heber for and during the period of her natural life; that Parcels 3 through 7 should be sold and the proceeds applied toward liquidating existing indebtedness on Parcels 1 and 2; that each party was entitled from September 1, 1944, to a drawing account of at least \$100 per month against the net income to which each might be entitled; that if the undivided one-half of the net income should be insufficient to care for either party because of illness, want or other necessity, or to

tain necessary medical or other assistance, so much of the principal or corpus should be used as necessary for such purpose; that any further indebtedness on the properties could be incurred only with the consent of the parties; that accurate books of account were to be kept and audited and that a written account was to be made on December 31st of each year of all assets and liabilities, receipts, disbursements, and net profits, and an annual settlement of any profits due. (I-R. 54-56.)

Pursuant to the termination agreement, deeds were executed containing the following language (I-R. 56-57):

(1) With respect to Parcels 1 and 2:

SECURITY-FIRST NATIONAL BANK * * * does hereby grant to EMMA M. STEEVE [Heber] * * * a life estate consisting of one-half of the net rents, issues and profits for and during the period of her natural life only, and to LILLIAN E. YAEGER * * * the remaining net income, together with title in fee, subject to such life estate, in and to that real property * * *.

(2) With respect to Parcels 3, 4, 5, and 6:

EMMA M. STEEVE [Heber] * * * does hereby grant to LILLIAN E. YAEGER * * * all that real property situate in the County of Orange, State of California, described as follows [describing Parcels 3, 4, 5, and 6]:

EXCEPTING AND RESERVING * * * to the Grantor, for and during the period of her natural life only, an estate consisting of one-half of the rents, issues and profits received or derived therefrom.

(3) With respect to Parcel 7:

LILLIAN E. YAEGER * * * does hereby grant to EMMA M. STEEVE [Heber] * * * a life estate consisting of one-half of the rents, issues and profits received or derived from all that real property * * *.

Subsequent to August 10, 1944, Parcels 3 through 6 were sold to third parties and the proceeds applied to reduce the indebtedness on Parcels 1 and 2. (I-R. 57.)

Parcels 1, 2, and 7 (hereafter sometimes referred to as the Fullerton properties) were retained, and it is the income from these properties that gives rise to the present tax controversy. (I-R. 57.)

The deeds were recorded in accordance with the termination agreement. Thereafter, at all times relevant hereto, Miss Yaeger continued to manage and control the Fullerton properties, taking charge of collecting the rents and paying the property taxes and other expenses of the properties. (I-R. 57.)

Miss Yaeger's purpose in causing Mrs. Heber to execute the termination agreement was to reshuffle their interests in the partnership properties in order to reflect the fact that Mrs. Heber, because of illness, had become unable to assist Miss Yaeger in any of the affairs of the partnership. When Mrs. Heber and Miss Yaeger executed the termination agreement, it was the belief and intention of each of them that the partnership theretofore existing between them was thenceforth terminated. Each of them was aware at that time that Mrs. Heber was receiving thereby a life estate in an undivided one-half of the Fullerton properties and that Miss Yaeger was also receiving, as a tenant in common a life interest in an undivided one-half of the properties, measured by Mrs. Heber's life, plus the entire ownership of the properties upon Mrs. Heber's death. (I-R. 57-58.)

The basic manner in which the former partnership properties were to be operated and maintained was significantly altered as a result of the execution of the termination agreement. Instead of continuing to acquire new properties, it was agreed that certain nonincome-producing properties were to be sold. Pursuant to the terms of the termination

reement, Miss Yaeger used the proceeds from the sales to effect substantial renovations of the Fullerton properties and to reduce the outstanding indebtedness thereon. Miss Yaeger also used a portion of the net rentals produced by the properties to effect these ends. (I-R. 57.)

After the execution of the termination agreement, Mrs. Heber moved to Los Angeles. Miss Yaeger remitted to Mrs. Heber the \$100 per month provided for in paragraph 6 of the termination agreement until January 1, 1948. Thereafter, Miss Yaeger ceased paying any monies to Mrs. Heber with respect to her interest in the Fullerton properties, and began to pay herself \$200 per month as a manager's salary, charging this amount against the rental income produced by the Fullerton properties. (I-R. 58.)

In January, 1949, Mrs. Heber sought legal counsel pertaining to her rights under the termination agreement. On August 4, 1949, Mrs. Heber initiated proceedings against Miss Yaeger in the Superior Court, Orange County, California. Mrs. Heber's complaint set up separate causes of action for rescission of the termination agreement, reformation, declaratory relief, and to quiet title. That court in an unreported opinion found, among other things, that Mrs. Heber was, by virtue of the termination agreement, vested with a life estate in and to an undivided one-half interest in the Fullerton properties for and during her life; that Miss Yaeger, by virtue of the termination agreement, acceded to ownership of the remainder interest in the properties; and that Miss Yaeger had not sold all of the property agreed to be sold

for the purpose of paying off the encumbrances on the Fullerton properties and that Miss Yaeger had not paid Mrs. Heber her full share of the income from the Fullerton properties. That court, moreover, in approving the report and account prepared by a referee, found in accordance therewith that Miss Yaeger had collected, as rents and income from the Fullerton properties, during the period in question, namely, from August 10, 1944, through December 31, 1952, the total sum of \$167,998.18; that she had expended \$101,926.50 for maintenance of the property, leaving a net income of \$66,071.68, of which Mrs. Heber was entitled to one-half, or \$33,035.84; and that Miss Yaeger had paid Mrs. Heber only \$5,942.39, leaving a balance of \$27,093.45 owed to her. The court held that in the determination of Mrs. Heber's share of the net income from the Fullerton properties, Miss Yaeger was not entitled to deduct depreciation on the properties. A final judgment was entered in accordance with these findings, and Mrs. Heber was awarded a total of \$27,093.45, plus interest from August 10, 1944, through December 31, 1952. On October 26, 1956, this judgment was affirmed on appeal by the District Court of Appeals, Fourth District, California, sub nom. Steeve v. Yaeger, 145 Cal. App. 2d 455, 302 P. 2d 704 (1956). (I-R. 58-60.)

Miss Yaeger paid the amounts awarded to Mrs. Heber pursuant to this judgment, as follows (I-R. 60):

<u>Year Paid</u>	<u>Payments on Judgment</u>	<u>Interest</u>
1955	\$ 9,086.39	--
1957	18,007.06	\$5,509.30
Total	\$27,093.45	\$5,509.30

During the years 1953 through 1955, the Fullerton properties had net income, adjusted in accordance with the decision in Steeve v. Yaeger, in the total amount of \$31,956.76. In accordance with the principles set forth in that decision, Mrs. Heber's share thereof was \$15,978.38. Payments to Mrs. Heber of her share of the net income from the Fullerton properties allocable to the years 1953, 1954, and 1955 were made as follows (I-R. 60):

<u>Year Paid</u>	<u>Amount</u>
1954	\$ 1,200.00
1955	1,100.00
1956	5,536.30
1957	8,142.08
1958	- -
Total	<u>\$15,978.38</u>

The following table shows the net income of the Fullerton properties in 1956 through 1958, and amounts received by Mrs. Heber (I-R. 61):

	<u>Net income from Fullerton Properties</u>	<u>Share of net income allo- cated on books to Mrs. Heber</u>	<u>Amount of net income actually received by Mrs. Heber</u>	<u>Total amount re- ceived by Mrs. Heber from Ful- lerton Properties</u>
1956	\$ 8,697.33	\$ 4,348.67	\$ 1,200.00	\$ 6,736.30
1957	10,063.55	5,031.78	4,348.67	36,805.17
1958	8,814.03	4,407.02	5,031.78	5,031.78
	<u>\$27,574.91</u>	<u>\$13,787.47</u>	<u>\$10,580.45</u>	<u>\$48,573.25</u>

During the taxable year 1956, Mrs. Heber reported the receipt of ordinary income in the amount of \$4,547.27 from the Fullerton properties. The Commissioner determined that Mrs. Heber during 1956 had received ordinary income from the Fullerton properties in the aggregate amount of \$9,884.96 and increased her taxable income that year by \$5,337.69. (I-R. 62.)

In her income tax return for 1957, Mrs. Heber reported the receipt from the Fullerton properties of \$5,840.38 and claimed that of that amount \$3,929.08 represented gain arising from the sale of a capital asset held for more than six months. Prior to 1957, Mrs. Heber had reported all money received by her with respect to her interest in the Fullerton properties as ordinary income. In 1957, after receiving payment of some \$36,805 in respect of her interest in the Fullerton properties, Mrs. Heber was advised by her accountant to treat all amounts received by her from the properties as proceeds from the sale or exchange of a capital asset held in excess of six months. The capital gain of \$3,929.08 reported in Mrs. Heber's 1957 income tax return attributed to the Fullerton properties, was determined by her accountant pursuant to a "RECOMPUTATION OF [HER] FEDERAL INCOME TAX FOR [THE] YEARS 1945 THROUGH 1956 INCLUSIVE." The accountant "recomputed" Mrs. Heber's income tax for those years (1) by deducting from her gross income as reported for each year the amount of income received by her from the Fullerton properties during such year and (2) by adding thereto an amount labeled "Capital Gain Resulting from Sale of Fullerton Properties." There is nothing in the record to indicate the ground upon which Mrs. Heber's accountant proceeded to recompute her net or taxable income during such years. (I-R. 62-63.)

The Commissioner increased Mrs. Heber's taxable income for the year 1957 as follows (I-R. 63):

Taxable income as disclosed by original return		\$ 7,921.53
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Additional income and unallowable deductions:

(a) Interest income	\$ 5,509.30	
(b) Judgment income	14,166.90	
(c) Ordinary income- Fullerton properties	<u>5,031.77</u>	<u>24,707.97</u>

Total		<u>\$32,629.50</u>
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Nontaxable income and additional deductions:

(d) Capital gain	2,258.54	
(e) Exemption	<u>600.00</u>	<u>2,858.54</u>

Taxable income as corrected		\$29,770.96
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The Commissioner explained these adjustments by stating in part, at Mrs. Heber had failed to report interest income in the amount of \$5,509.30; that (I-R. 63)--

the net amount of \$14,166.90 received by you from a judgment in 1957 constitutes taxable income for 1957 * * * that you are not entitled to compute the tax on such income under the provisions of sections 1301-1307 of the Internal Revenue Code of 1954

and that she received as ordinary income \$5,031.77 as opposed to the \$3,929.08 reported by her as long-term capital gain from the Fullerton properties. (I-R. 63.)

Mrs. Heber's income tax return for 1958 showed that she received \$5,031.78 from the Fullerton properties. Of that amount, \$3,923.50 was reported as long-term capital gain. The Commissioner determined that "such gain is taxable as ordinary income in the amount of \$1,298.74" and increased Mrs. Heber's taxable income by that amount. (I-R. 64.)

The Tax Court held (I-R. 65-74) that, since Mrs. Heber prepared her returns on the cash method of accounting, she was taxable only

upon receipt of amounts paid to her in respect to her life estate in the Fullerton properties, and that she was entitled to depreciation. Therefore, amounts received in the years 1956 through 1958 representing payments from the Fullerton properties for the years after December 31, 1952, were adjusted to decrease 1956 taxable income by \$3,243.05, and to increase taxable income for 1957 and 1958 by \$8,149.46 and \$1,663.76, respectively. (I-R. 71, 90, 96.) The Tax Court also held that the tax attributable to the receipt of damages as a result of the decision in Steeve v. Yaeger, supra, might not exceed the aggregate of the increases in her taxes for the years 1948 through 1952 had the allocable portions been included in her gross income for such years pursuant to Section 1305 of the Internal Revenue Code of 1954. Consequently, 1957 income tax was increased by \$1,915.68. (I-R. 71-72, 90.)

With respect to Miss Yaeger, the Commissioner's statutory notice of deficiency increased her taxable income for the year 1955 by \$7,207.88. He explained this action by stating (I-R. 64):

(a) It is determined that your income from the "Fullerton Properties" totaled \$11,990.62 instead of the \$4,782.74 reported on your income tax return for 1955.

The Commissioner also decreased Miss Yaeger's taxable income by the \$2,400 management fee which the court in Steeve v. Yaeger, supra, ruled should be returned to the net income of the Fullerton properties. The Commissioner increased Miss Yaeger's taxable income for the years 1956 through 1958 by determining that the entire net income of the Fullerton properties during each of these years, rather than one-half of the net income as reported by Miss Yaeger, should be included in

or taxable income. (I-R. 64.) The Commissioner further determined in the deficiency notice that Miss Yaeger was not entitled to deductions for the respective amounts of \$9,086.39 and \$3,766.32 during 1955 and 1957 as a result of payments on the judgment awarded Mrs. Heber in the decision Steeve v. Yaeger, supra. (I-R. 64-65.)

The Tax Court held (I-R. 74) that Miss Yaeger was taxable in the years 1955 through 1958 on only half the net rental income from the Fullerton properties as ordinary income.^{2/} To protect the revenue, the Commissioner has filed a petition for review against Miss Yaeger (I-R. 97-100), contending in the alternative that all the income from the properties was taxable to her, so that in the event this Court should reverse the Tax Court and should hold that Mrs. Heber is not taxable on amounts she received from the properties, such amounts would be taxable to Miss Yaeger.

SPECIFICATION OF ERRORS RELIED UPON BY THE COMMISSIONER

In the event this Court should reverse the Tax Court and should hold that Mrs. Heber and Miss Yaeger during the taxable years 1955 through 1958 did not each own a one-half interest in the net income produced by the Fullerton properties, and, therefore, that Mrs. Heber is not taxable on payments she received in those years from Miss Yaeger under the termination agreement of August 10, 1944, of her share of such rental income, then the Tax Court should also be reversed with respect to Miss Yaeger, and the entire amount of the rental income should be held to be taxable income to Miss Yaeger during the years involved.

The Tax Court also sustained (I-R. 74) the Commissioner's disallowance of deductions in 1955 and 1957 which are not here involved.

SUMMARY OF ARGUMENT

1. Mrs. Heber's share of rental income from the Fullerton properties which she received in 1956 through 1958, is taxable as ordinary income rather than as capital gain. The Tax Court correctly held that even if the termination agreement effected a sale of Mrs. Heber's partnership interest, her share of the rental income from the properties is taxable as ordinary income. If Mrs. Heber sold her partnership interest, what she received for that interest was a life estate in one-half of the Fullerton properties, as the California state court decision involving the taxpayers here so holds. This decision is controlling as to the nature of Mrs. Heber's property interest. If there was a sale or exchange in 1944, Mrs. Heber had gain or loss in that year in the amount of the difference between the value of the life estate she received and the value of the partnership interest she gave up; but regardless of whether she had gain or loss in 1944, the fact remains that she received a life estate from which she realized income in the taxable years 1956 through 1958, in the form of rent which is taxable as ordinary income rather than as capital gain. Under Section 61(a) of the 1954 Code, taxable income includes all gains, from whatever source derived, including rents. What Mrs. Heber received was her share of the rents, issues and profits from her ownership interest, taxable as ordinary income and not as capital gain.

The capital gains provisions are narrowly construed, and where Mrs. Heber retained the normal incidents of ownership, without any shift of economic benefit or control of the property, capital gains

treatment should be denied. The capital gains provisions do not warrant extending capital gains treatment to annual receipts derived from a continuing risk-bearing participation in the future income of an asset.

No concession of Government counsel required the Tax Court to determine whether there was a sale of Mrs. Heber's partnership interest. Since Mrs. Heber's receipt of a life estate is acknowledged and must be accepted in view of the California court's decision, there was no necessity for the Tax Court to determine whether the 1944 agreement resulted in a sale of her partnership interest. Moreover, it is well settled that the parties to a case may not stipulate an issue of law, and when they undertake to do so such stipulation is not binding upon the court, for the legal effect of a transaction is a question of law. To prevent injustice, a federal court may disregard and set aside a stipulation which has been inadvertently entered into by Government counsel.

There was no sale of a capital asset. The record shows that there were no negotiations for sale such as normally accompany the sale of property; there is no language in the termination agreement consonant with a sale or exchange; provisions in the termination agreement indicate that the parties intended, as the California state court reasonably concluded, that Mrs. Heber should have a vested interest in the properties themselves, not merely the right to income. Thus, the agreement provided that both parties should agree with respect to contracting any indebtedness; that both dispose of all properties except Parcels 1 and 2; and that each had the right to invade the

corpus of the properties if the net income should be insufficient to care for them in the event of illness, want, or other necessity. Mrs. Heber's understanding of her property interest is shown by the fact that she reported the net income from the properties as ordinary income until 1957. The parties simply changed the nature of their ownership interests in the Fullerton properties and Mrs. Heber continued to be entitled to one-half of the rent income during her lifetime. In contrast to the usual sale, there was no fixed amount stated as the "purchase price", no assets were pledged for its payment, Miss Yaeger was not personally liable, no down payment was made, and no other assets were pledged or guaranty given. Mrs. Heber bears the risk of whether the properties will prove productive in the future.

2. In the alternative, if this Court reverses the Tax Court on Mrs. Heber's appeal, the Tax Court should also be reversed on the Commissioner's appeal against Miss Yaeger. In that event, it is urged that one-half the net rental income held by the Tax Court to be taxable to Mrs. Heber as ordinary income actually belongs to Miss Yaeger and was paid to Mrs. Heber as purchase money. Thus it should be taxed to Miss Yaeger as ordinary income (rent), with the result that she, as the sole owner of the Fullerton properties, is taxable on the entire income from them.

ARGUMENT

I

MRS. HEBER'S SHARE OF RENTAL INCOME FROM THE
FULLERTON PROPERTIES, RECEIVED IN 1956 THROUGH
1958, IS TAXABLE AS ORDINARY INCOME RATHER
THAN AS CAPITAL GAIN

The sole issue on these appeals is as to how that portion of rental income from the Fullerton properties which was paid over to Mrs. Heber in the taxable years (1956 through 1958) should be treated. Mrs. Heber contends (Br. 8-27) that the termination agreement of August 10, 1944, executed by her and Miss Yaeger (Ex. 9-I, I-R. 119-126) resulted in neither a purchase or exchange of Mrs. Heber's partnership interest, which was a capital asset, and that under Section 1201 of the Internal Revenue Code of 1954, she is entitled to report what she received as capital gain. However, the Tax Court sustained the Commissioner's determination that the amounts paid to Mrs. Heber were taxable as ordinary income rather than as capital gain. Decision was based upon (1) approval and acceptance of the holding in Steeve [Heber] v. Yaeger, 15 Cal. App. 2d 455, 302 P. 2d 704 (I-R. 46), that under the termination agreement of 1944 Mrs. Heber received a life estate in an undivided one-half of the Fullerton properties and (2) a holding that it was immaterial whether or not Mrs. Heber had sold her former partnership interest to Miss Yaeger in return for this life estate, since the income from the Fullerton properties she received would in any event be taxable to her as ordinary income. We submit that the Tax Court was correct and, accordingly, that there is no merit to Mrs. Heber's contention.

- A. The Tax Court correctly held that, even if the termination agreement effected a sale of Mrs. Heber's partnership interest, her share of the rental income from the properties is taxable as ordinary income

One of Mrs. Heber's principal contentions (See Br. 22) is that the Tax Court erred in not determining whether the August 10, 1944,

termination agreement resulted in a sale or exchange of her partnership interest for a life estate in one-half of the Fullerton properties. But it was plainly unnecessary for the Tax Court to make such a determination. As that court said (fn. 7, R. 71), the only questions which would be resolved by such a determination are (1) whether Mrs. Heber had gain or loss in 1944 upon her receipt of the life estate and (2) the correct bases of Mrs. Heber and Miss Yaeger in the respective assets--questions which are not presented in this case.

Assuming that Mrs. Heber sold or exchanged her partnership interest, what she received for that interest was a life estate in one-half of the Fullerton properties. This is indisputable in view of the state court decision in Steeve v. Yaeger, supra, which is controlling as to the nature of Mrs. Heber's property interest.^{3/} If there was a sale or exchange in 1944, Mrs. Heber had gain or loss in 1944 in the amount of the difference between (1) the value of the life estate she received and (2) the value of the partnership interest she gave up.^{4/} But we are not concerned here with Mrs. Heber's liability for tax in 1944. And, regardless of whether she had gain or loss in 1944, the

3/ See Commissioner v. Sunnen, 333 U.S. 591, 598; Morgan v. Commissioner, 309 U.S. 78, 80, rehearing denied, 309 U.S. 626; Commissioner v. Siegel, 250 F. 2d 339 (C.A. 9th); Goold v. Commissioner, 182 F. 2d 573 (C.A. 9th).

4/ Capital gain is "gain from the sale or exchange of a capital asset" Section 1222(3) of the 1954 Code, supra; the "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis" (Section 1001(a)); and the "amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received" (Section 1001(b)). Since a life estate is "property (other than money)," it is only the "fair market value" of the life estate that enters into the computation of capital gain.

It remains that she received a life estate from which she realized income in the taxable years involved here (1956 through 1958) in the form of rent, which is taxable as ordinary income rather than as capital gain.

If Mrs. Heber is arguing that the life estate and the income from it should be treated as one and the same thing, there is no merit in her argument. The rental payments to Mrs. Heber, being rent, were ordinary income unless they constituted a part of the sales price of her partnership interest. But they obviously did not (assuming there was a sale). What she received for her partnership interest was "property" consisting of a life estate in one-half of the Fullerton properties, not the cash payments of rent which were made to her. The rent was income from her property interest, the life estate, not a payment made to her by Miss Yaeger.

Section 61(a) of the Internal Revenue Code of 1954, supra, provides that taxable income includes all gains from whatever source derived including rents. Section 1.61-8 of Treasury Regulations on Income Tax (1954 Code) provides that gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. Under the facts presented here, what Mrs. Heber received was her share of the rents, issues and profits from her ownership interest, taxable as ordinary income, and not as capital gain. See Est v. Commissioner, 155 F. 2d 121, 157 F. 2d 331 (C.A. 9th). Indeed, Mrs. Heber continued to receive the same share of proceeds from the Fullerton properties after the agreement that she had before. Income

is taxable to the one who earns it, or the one who owns the property which gives rise to the income. Lucas v. Earl, 281 U.S. 111. Joint tenancy and tenancy in common both consist of undivided interests in property, and the net income from property so held is generally taxable in proportion to shares of ownership in the property. I.T. 2082, III-2 Cum. Bull. 176 (1924).

The capital gains provisions have always been narrowly construed to protect the revenue and to deny the preferential lower rates to taxpayers attempting to cloak ordinary business income as the proceeds of the sale of a capital asset. Corn Products Co. v. Commissioner, 350 U.S. 46, 52; Hort v. Commissioner, 313 U.S. 28, 31. Here there was neither form nor substance of a sale. Mrs. Heber retained the normal incidents of ownership, without any shift of economic benefit or control of the property purportedly transferred. Transactions "which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." Higgins v. Smith, 308 U.S. 473, 476. It is clear that Congress never intended to accord capital gains treatment to anything more than a realization upon the present value of an asset at the time of its transfer, and that any application of the provisions that permits the fruits of a continued sharing in the future gains and profits produced by the asset to be taxed only as capital gains would be basically offensive to the purposes of the capital gains provisions. Thus the reason given for the special tax treatment first accorded to capital gains by the Revenue Act of 1921 was that (H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10-11 (1939-1 Cum Bull. (Part 2) 168, 176)):

The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum * * * in the year in which the profit is realized.

The only thing that was intended to be given preferential treatment was the realization, by a sale, of "gains and profits earned over a series of years" in the past and thus reflected in the present value of the asset at the time of the sale.

The same limitation is implicit in the requirement of the statute that, for capital gains treatment the asset must have been held for a stated period (now six months) prior to its "sale," a requirement that makes sense only if the gain realized and accorded capital gains treatment represents values that accrued during that period--i.e., up to, but not after the date of the sale.

The conclusion is equally dictated by the Supreme Court's repeated recognition that the purpose of the capital gains provisions was to afford relief from the application of the steeply progressive ordinary rates to the realization in a single year of values that may have accrued over many years in the past. Commissioner v. Gillette Motor Corp., 364 U.S. 130, 134; Commissioner v. P. G. Lake, Inc., 356 U.S. 20, 265; Burnet v. Harmel, 287 U.S. 103. That purpose obviously does not warrant extending capital gains treatment to annual receipts derived from a continuing risk-bearing participation in the future income from the asset.

The case of Commissioner v. Peterman, 118 F. 2d 973 (C.A. 9th), involving an involuntary tax sale of realty, contrary to the taxpayer's

contention (Br. 16) is in no way analogous. The other cases relied upon by the taxpayer (Br. 22, 25-26) are also inapposite. Those cases-- United States v. Adamson, 161 F. 2d 942 (C.A. 9th); McAllister v. Commissioner, 157 F. 2d 235 (C.A. 2d); Bell's Estate v. Commissioner, 137 F. 2d 454 (C.A. 8th), and Estate of Camden v. Commissioner, 139 F. 2d 267 (C.A. 6th)--deal with gain from the sale of capital assets, not the treatment of income derived from such assets.

B. The Tax Court was not required to determine whether there was a sale of Mrs. Heber's partnership interest

Mrs. Heber asserts (Br. 11-12, 23-24) that the Tax Court incorrectly ignored a so-called "stipulation" by Government counsel and decided the case on an "irrelevant theory of its own" (Br. 11). The fact is that Government counsel conceded (II-R. 14) that, if a sale occurred in 1944, "the payments made by Miss Yaeger to Mrs. Heber would simply be consideration for the sale of a capital asset, that this would be capital gains, but in that event Miss Yaeger would be taxable on the entire income from the property." Obviously, counsel was referring to a sale by Mrs. Heber of her partnership interest as including her entire interest in the Fullerton properties in consideration of cash payments by Miss Yaeger in the amount of one-half of the rent. The concession does not require a determination as to whether there was a sale by Mrs. Heber when, as is so clearly true, if there was a sale what Mrs. Heber received on the sale was a life estate rather than a right to receive one-half of Miss Yaeger's rental income. Indeed, as the Tax Court noted (I-R. 21, fn. 6), Mrs. Heber makes no

attention that she sold her partnership interest for a promise to pay percentage of the net profits to her and thus all of the rent belonged Miss Yaeger and was paid to her (Mrs. Heber) only as purchase money. It follows that, since the receipt of a life estate is acknowledged-- must in any event be accepted on this record and the California Court's decision--there was no necessity for the Tax Court to determine whether the 1944 termination agreement resulted in a sale of Mrs. Heber's partnership interest.

Moreover, it is well settled that the parties to a case may not stipulate an issue of law, and when they undertake to do so such stipulation is not binding upon the court and will be disregarded, since the legal effect of a transaction is a question of law. Estate of Sanford v. Commissioner, 308 U.S. 39, 51, rehearing denied, 308 U.S. 637; Swift & Co. v. Hocking Valley Ry. Co., 243 U.S. 281, 289; Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F. 2d 8, 231 (C.A. 9th); Davis v. Commissioner, 241 F. 2d 701, 703 (C.A. 9th); Daugaard v. Hawkeye Security Insurance Co., 239 F. 2d 351, 354 (C.A. 8th); Commissioner v. Union Pac. R. Co., 188 F. 2d 950 (C.A. 2d); Abb v. Commissioner, 121 F. 2d 1015 (C.A. 5th); London-Butte Gold M. Co. v. Commissioner, 116 F. 2d 478, 479-480 (C.A. 10th).

It is also to be noted that a federal court may disregard and set aside a stipulation which has been inadvertently entered into by government counsel. American Food Products Co. v. United States, 73 Ct. Cl. 526; Federal Export Corp. v. United States, 25 F. Supp. 109, 1 (Ct. Cl.), certiorari denied, 308 U.S. 590; Rule 31(b)(5), Rules

of Practice, Tax Court Rules of the United States (Rev. 1958, 1964 ed.). This Court so pointed out in Berry v. Commissioner, 254 F. 2d 471, relied on by Mrs. Heber (Br. 24) and that case was merely remanded for clarification of the stipulation.

The factual situation in Burstein v. United States^{5/}, 232 F. 2d 19 (C.A. 8th) differs materially from the case now under consideration. The Burstein case related to a stipulation as to essential facts necessary to determine the amount of damages involved in the action, and did not relate, as here, to a legal theory or conclusion to be drawn from the facts.

C. There was no sale of a capital asset

Mrs. Heber's counsel admitted (II-R. 10) that there were no negotiations for sale such as normally accompany the sale of property. There is no language in the termination agreement consonant with a sale or exchange. The preamble of the agreement states (I-R. 121) that the parties desired "to clarify and modify the terms" of the 1939 co-partnership agreement and deeds, and "covenant and agree by the terms hereof to partition and divide said properties". The termination agreement further provided (I-R. 123) that no indebtedness should be contracted on the properties without the concurrence of both parties, that each must sign any document necessary to renew existing indebtedness; that if the net income of the properties should be insufficient to care for both parties in the event of illness, want, or other necessity, either could use so much of the principal or corpus of the properties as necessary for her maintenance and care; that (I-R. 122)

^{5/} The taxpayer's brief (p. 24) inadvertently cites this case as "Bernstein vs. U. S., 253 F 2d 19 (C.A. Mo. 1956)."

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with parties, not Miss Yaeger alone, agreed to dispose of all property of the former partnership except Parcels 1 and 2 and to use the proceeds toward payment of the indebtedness on those parcels; and that (I-R. 124) each party was entitled to a yearly accounting of net profits. The various transfers necessary to carry out the agreement were by deeds which were duly recorded. (I-R. 45-46, Exs. 10-J, 11-K, and 13-M.) Moreover, Mrs. Heber's understanding of her property interest is shown by the fact that she reported the net income from the properties as ordinary income until 1957. (I-R. 62.) Not to be overlooked, also, is the fact that the parties simply changed the nature of their ownership interests in the Fullerton properties, albeit in such a way that Mrs. Heber continued to be entitled to one-half of the rent income during her lifetime.^{6/}

Mrs. Heber's attempt to show that the termination agreement was not a true agreement (Br. 5-6, II-R. 8) is controverted by the refusal of the California court to rescind the agreement. Steeve v. Yaeger, supra. As the Tax Court concluded, we must accept the termination agreement, as interpreted by the California court, in defining the property interests of the parties. Commissioner v. Sunnen, 333 U.S. 591;

The record shows that in 1939 Mrs. Heber's initial investment in the partnership properties was approximately \$4,500 (Ex. 15-Y); that at the time of the termination agreement her interest in the net worth of the partnership was approximately \$12,450 (Ex. 17); and that she had received approximately \$80,000 from her partnership interest from 1944 to 1963 (II-R. 52), approximately \$60,000 of which was in the years 1954 through 1958 (Ex. 14-N). She had received the benefit of a distribution from corpus when she was ill and the income from the properties was insufficient for her case. Steeve v. Yaeger, supra.)

Morgan v. Commissioner, 309 U.S. 78; Commissioner v. Siegel, 250 F. 2d 339 (C.A. 9th); Goold v. Commissioner, 182 F. 2d 573 (C.A. 9th).

In contrast to the instant transaction, the usual sale is a transfer of property in which the transferor completely severs his relationship to the property and receives either full payment in cash, or a promise to pay a fixed amount, secured by the pledging of other assets or the personal liability of a solvent guarantor, or paid by a substantial down payment, with the property itself pledged to secure the payment of the balance of the purchase price. Here no fixed amount was stated as the "purchase price", no assets were pledged for its payment, Miss Yaeger was not personally liable, no down payment was made, and no other assets were pledged or guaranty given. The rents she will receive in the future, are entirely dependent on what income is produced by the properties and she bears the risk of whether the properties will prove productive.

II

IF THIS COURT REVERSES THE TAX COURT ON MRS. HEBER'S APPEAL, THE TAX COURT SHOULD ALSO BE REVERSED ON THE COMMISSIONER'S APPEAL AGAINST MISS YAEGER

The Commissioner determined deficiencies against Miss Yaeger for the years 1955 through 1958 in the total amount of \$14,109.04, resulting from issues on appeal and some that are not here involved. (I-R. 9-14.) Under the Tax Court's decision, there are deficiencies for those years of \$5,902.23 (I-R. 87) as to which Miss Yaeger has not appealed.

The Commissioner's primary position, set forth in the earlier portions of this brief, is that the Tax Court was correct in taxing

half the rental income from the Fullerton properties to Mrs. Heber. However, the Commissioner has filed a petition for review against Miss Yaeger (I-R. 97-100) to protect the revenue and we urge, in the alternative, that the one-half of the net rental income held by the Tax Court to be taxable to Mrs. Heber as ordinary income actually belonged to Miss Yaeger and was paid to Mrs. Heber as purchase money. Thus, it should be taxed to Miss Yaeger as ordinary income (rent), with the result that she, as the sole owner of the Fullerton properties, should be taxable on the entire income from them.

CONCLUSION

On Mrs. Heber's appeal, the decision of the Tax Court is correct and should be affirmed. If this Court reverses the Tax Court on Mrs. Heber's appeal, the Court should also, on the Commissioner's appeal, reverse the Tax Court's decision as to Miss Yaeger. If this Court affirms the Tax Court on Mrs. Heber's appeal, the Commissioner's protective petition for review against Miss Yaeger should be dismissed.

Respectfully submitted,

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NOVEMBER, 1965.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: _____ day of _____ 1965.

CAROLYN R. JUST,
Attorney.